

MONTANA MICROBUSINESS FINANCE PROGRAM

THIRD PARTY EVALUATION

Executive Summary



for the
US WEST Foundation
Montana Legislature
Montana Department of Commerce

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January 3, 1995

In 1991, the Montana State Legislature approved an appropriation from the Coal Severance Tax Trust Fund to finance the creation of the Montana Microbusiness Finance Program. The purpose of the Program is to create, develop, and finance businesses with fewer than ten full-time employees and which generate less than \$500,000 per year in gross revenues. The Program is designed to support local efforts at economic development and are currently managed by eleven community based non-profit Microbusiness Development Corporations (MBDCs).

The US WEST Foundation through its REVIVE Program provided \$390,000 for local technical assistance and MBDC operations. The US WEST Foundation has subsequently granted an additional \$25,000 to the Department of Commerce to contract a Third Party Evaluation of the Microbusiness Finance Program. In addition, the Montana Legislature requires an evaluation of the program for the 54th Legislature describing the cost/benefit to Montana of the distribution of \$3.25 million of Coal Tax Trust Fund principal. The attached Executive Summary of the Third Party Evaluation responds to both requests. The Department of Commerce and the Microbusiness Advisory Council and Legislative Panel thank the Third Party Evaluators, Jim Boyer and Larry Nordell, for their thorough and extensive evaluation.

The program is new, with four MBDCs lending for twenty-seven months, two MBDCs lending for twenty-four months, two MBDCs lending for twelve months and four MBDCs lending for less than nine months. Performing a cost/benefit analysis on a new program with little historical performance is difficult. The Third Party Evaluators based their five year projections of cash flow on conservative assumptions; however, the limited actual performance needs to be remembered as part of any interpretation of this evaluation. With this caveat we recommend this Executive Summary to its readers. The Microbusiness Third Party Evaluation Technical Report and a six minute video of four businesses

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financed through the Program are available upon request through the Montana Department of Commerce.

The Department of Commerce is pleased to have been able to facilitate the Microbusiness partnerships between communities and their local businesses. I believe that in the long run it will be the efforts of local communities to which we can contribute the success of the program. We value these partnerships and look forward to translating this beginning into a long-term strategy that results in a sustainable business capital formation program for Montana.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Jon Noel', is written over a large, faint, circular stamp or watermark.

Jon Noel
Director

ABSTRACT

The purposes of the third-party evaluation of the Microbusiness Finance Program are: (1) to assess how well the MBFP is achieving the program goals set forth by the Montana Legislature and the US West Foundation; (2) to determine whether the benefits of the program justify its costs; and, (3) identify issues and provide recommendations for improving program design and implementation. The evaluation is funded by the U.S. West Foundation.

The evaluation covers the initial years of MBFP implementation: from July 1, 1992 through October 1, 1994. Five Microbusiness Development Corporations (MBDCs) began making microbusiness loans during FY 1992-93. Six additional MBDCs began lending in FY 1993-94. MBDCs are expected to achieve mature volumes of lending in their fourth year of operation.

Achieving Program Goals In the fall of 1994, the MBFP is established statewide and MBDCs are fostering new business development in all regions of Montana. The program is lending to businesses which would otherwise not receive financing; serving economically disadvantaged populations; creating and retaining jobs; and, increasing state tax revenues. The program's overall lending volume is slightly below expectations; some MBDCs are achieving desired lending volumes and some are not. Department of Commerce administrative costs are being covered by program interest earnings. Expenses of MBDCs are far greater than their interest income, and the costs of regionally implementing the program are being underwritten by grant moneys. It is too early to determine whether loan funds will be self-perpetuating. The ability of MBDCs to replenish loan fund principal after loan losses is uncertain. The program has not caused perceptible decreases in statewide public assistance costs, but has contributed to reductions in payments to individual borrowers.

Program Benefits and Costs Results of the analysis of MBFP benefits and costs are favorable. Total benefits of the program to Montana, based on projected performance of microbusinesses funded by loans made through October 1, 1994, are \$5.53 million using a profit measure, and \$16.71 million using a value added measure. Costs expended up to that point are \$0.71 million. Net benefits are \$4,820,000 and \$15,990,000, benefit-cost ratios for Montana are \$7.8 to \$1 and \$23.5 to \$1, respectively. Estimates of net benefits to Montana attribute benefits to state government and the general public, but assign costs only to state government (mainly foregone Coal Trust interest earnings and losses of loan fund principal). Montana benefits are leveraged by resources put into the program by the MBDCs and others. A societal perspective counts the costs of these resources. Total societal benefits for the two measures are \$4,710,000 and \$16,710,000, and societal costs are \$1,660,000. Societal net benefits are \$3,050,000 and \$15,050,000, and benefit-cost ratios are \$3.0 to \$1 and \$10.6 to \$1, respectively.

Program Issues The Microbusiness Finance Program has established a generally positive record, but issues must be resolved if its long-term promise is to be realized. Foremost are improving the volume of lending by the MBDCs, ensuring the loan funds can survive loan losses, achieving greater MBDC self-sufficiency, and enlarging the loan funds and raising the maximum size of loans permitted under the program.

Program Status on October 1, 1994

- 11 regional Microbusiness Development Corporations (MBDCs) and one statewide MBDC have been certified by the Department of Commerce (DOC) to manage 13 loan funds
- \$3.25 million in Coal Tax Funds has been loaned to MBDCs
- MBDCs have raised \$736,000 in local matching funds

- The Department of Commerce (DOC) has solicited \$890,000 in grants (mainly used to fund MBDC operations and training)
- a total of 186 loans were made to Montana microbusinesses
- a total of 165 individual businesses received loans
- of businesses receiving loans- 39 percent were start-ups, 39 percent were operating on a limited scale (part-time), and 23 percent were in full operation
- an estimated 150 of the businesses were operative (10-94)
- an estimated 340 persons were employed by businesses receiving loans (10-94)
- the total amount of loans made by MBDCs was \$1.86 million
- the average loan size was about \$10,000
- 157 loans were outstanding, valued at \$1.25 million
- 30 loans were fully repaid, valued at \$221,000
- 10 loans had been written-off, valued at \$81,610
- 18 loans were delinquent, valued at \$22,000
- 4 loans were in default, valued at \$43,128
- the Department of Commerce had received \$220,000 in interest payments from MBDCs (over 27 months)
- a state reserve fund was financed at \$20,000 (10-94)

ACHIEVING PROGRAM GOALS

Summary of Program Goals

The Microbusiness Development Act was passed during the 1991 Montana Legislature and amended in the 1993 session. The legislation defines goals and also prescribes operating parameters for the Microbusiness Finance Program. Microbusiness loans and associated services were to be available statewide. The program was to foster economic development by prompting small business formation and growth. It was to provide capital to businesses without access to conventional business loans. It was to provide entrepreneurial training and assistance to inexperienced individuals starting new ventures.

The legislation's fiscal note further indicated the program was to foster job creation and retention, assist low-income individuals climb out of poverty, reduce state public assistance costs, and increase state tax revenues.

Enabling legislation provided for the establishment of 12 regional and one statewide Microbusiness Development Corporations and set aside money from the Coal Tax Trust Fund for loans of up to \$250,000 to each loan fund. The funds were to be loaned to microbusinesses, defined as businesses with under \$500,000 in annual sales and no more than 10 employees.

The program's loan funds also were expected to be self-perpetuating. Successive rounds of lending, repayment of loans, and re-lending would create a permanent and potentially expanding pool of loan fund capital. The program also was expected to become financially self-sufficient. Montana Department of Commerce and MBDC administrative costs were to be covered mainly by interest earnings from outstanding loans.

The US WEST Foundation is a strong supporter of the Microbusiness Finance Program and has contributed \$415,000 towards its implementation. The US WEST's expectations for the program in 1994 are: total loans- \$4,333,000; jobs created or retained- 860; welfare/UI caseload reduction- 260; dollars loaned to jobs created/retained ratio- \$5,000 per job; business survival rate- 80 percent; and a loan loss rate at or below 3.5 percent.

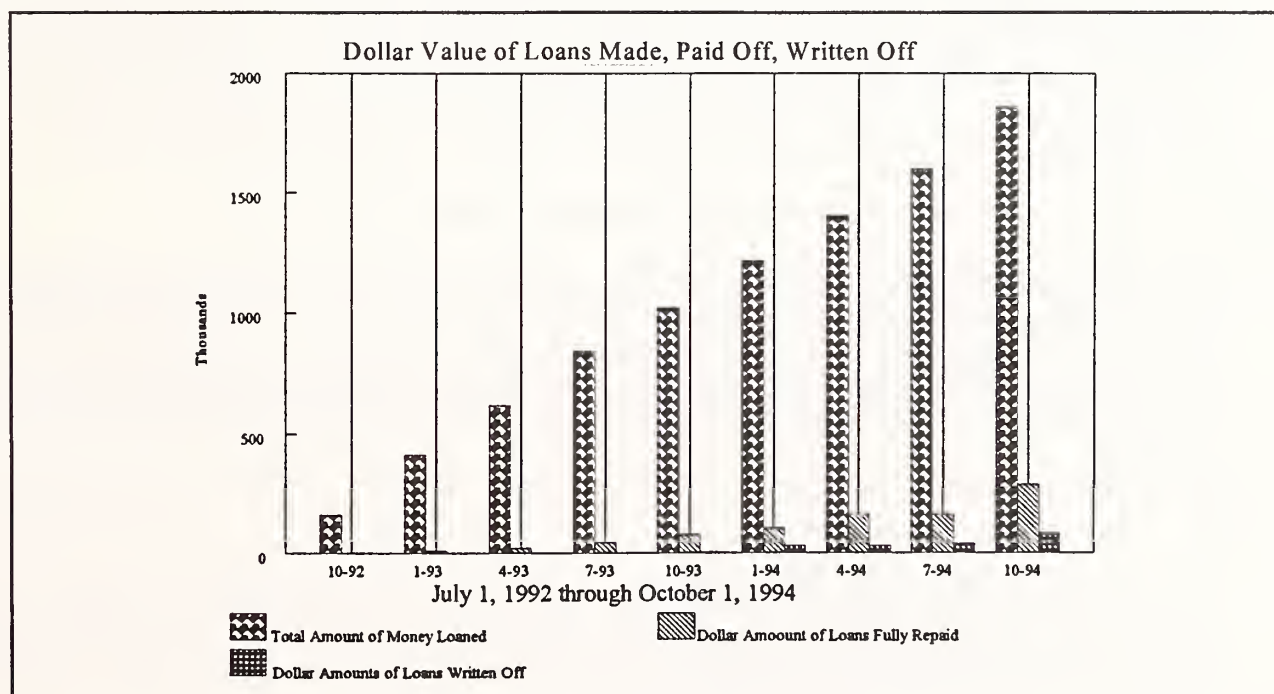
Program Performance

- Establish and fund program statewide

Microbusiness loans and services are available statewide. The Department of Commerce certified one statewide and 12 regional Microbusiness Development Corporations. One MBDC covers two regions (Glendive and Miles City). DOC distributed \$3.25 million to MBDCs after they successfully raised required matching funds.

- Foster business formation and growth

MBDCs have made 186 loans totalling \$1.86 million to Montana microbusinesses. About 165 individual businesses have received loans. **Seventy percent of these businesses indicated they would not have been able to "open or keep open" without their microbusiness loan.** Another 19 percent indicated business development would have been less without the loan.



- Provide capital to business enterprises without access to conventional business loans.

An estimated two-thirds of microbusiness clients inquired about a loan from a private lender before applying for a microbusiness loan. Most MBDCs require borrowers to investigate a private bank loan before applying for a microbusiness loan. MBDC interest rates are 1-3 percentage points above bank rates, which also tends to screen borrowers with access to conventional financing.

- Provide entrepreneurial training and assistance to inexperienced individuals

More than two out of three borrowers had no prior experience in owning and operating their own business. Microbusiness owners identified MBDCs as the most frequently used resource for business start-up information. Three-quarters of the program borrowers also received post-loan assistance from their MBDC; and, half continue to receive business advice on a monthly basis.

- Serve economically disadvantaged populations

The majority of microbusiness loan recipients are from target populations (low-income, minorities and women). An estimated 36 percent of loans have been made to low income clients; 60 percent of the loans have been made to women; and 15 percent have been to minorities.

- Create and retain jobs

In the fall of 1994, an estimated 340 full- and part-time paid jobs are supported by businesses receiving microbusiness loans (270 FTEs). About 50 unpaid workers (including business owners and owner family members), may eventually become paid workers. Of the microbusinesses with paid employees, 49 percent said they would not have employees, and another 14 percent said they would have fewer employees had they not received a microbusiness loan.

- Rate of lending by MBDCs

MBDC contracts with DOC specify performance targets for lending of microbusiness loan fund principal. In the fall of 1994, **MBDCs were contractually obliged to have \$1.44 million in outstanding loans and had loaned out about \$1.25 million.** A point of concern is that 6 of the MBDCs did not meet their contract targets. The six have fallen short by amounts varying from \$5,000 to \$104,000. In addition, the Statewide MBDC has incurred organizational difficulties, and has made no loans. The rate of lending for some MBDCs declined markedly after a high level of initial activity.

- Achieve long-term financial self-sufficiency for DOC and MBDCs

Interest earnings will be adequate to cover the Department of Commerce's administrative costs. Based on the initial years of program operation, **interest earnings accruing to MBDCs will fall far short of covering the costs in administering the program.** At maturity, annual aggregate costs for regionally administering the Microbusiness Program will likely exceed \$500,000. Annual interest earnings accruing to MBDCs are **likely to provide less than half of needed operating revenues.**

- Create self-perpetuating loan fund

Ten of the 11 MBDCs have yet to loan out all of their original lending capital. **It is too early to determine whether MBDCs will be able to maintain and/or expand their loan funds.** Long-term maintenance of the loan fund requires that MBDC earnings, or outside funding be sufficient to

replenish losses to fund principal due to bad loans. Into the fall of 1994, only about 4 percent of microbusiness loans had been written off, but this rate is likely to increase as the program matures. MBDCs are attempting to establish Loan Loss Reserve Funds to sustain their loan fund principal. However, **interest earnings appear to be inadequate to serve as a primary source for MBDC operations funds and also be used to replenish loan losses.**

The Havre MBDC is achieving the program objective of replenishing its loan fund over time. The Bear Paw Development Corporation, the Havre MBDC, successfully loaned out all of its original lending capital, and used borrower loan repayments to rebuild its loan fund's principal. Havre is now making second generation loans. The Havre MBDC has yet to incur any loan losses.

- Increase state tax revenues

In 1994, microbusiness owners and employees are estimated to **pay around \$200,000 in State of Montana income taxes.** Microbusinesses also are subject to state and local property taxes, and contribute to state revenue from motor fuel taxes. Individual businesses are also subject to other Montana taxes and fees. Most microbusinesses are still too small to contribute importantly to Montana tax revenues.

- Help people climb out of poverty/lowering state public assistance costs

Financing of microbusinesses thus far has not caused discernible reductions in state public assistance costs. The Montana Department of Social and Rehabilitative Services is in the process of identifying the number of microbusiness borrowers receiving some type of public assistance payment. Few microbusinesses have promptly produced substantial owner earnings, and it is premature to measure program impacts on the incidence of poverty or public assistance costs. If businesses achieve long-term success, low income clients will eventually climb out of poverty and discontinue use of public assistance programs. Anecdotal evidence indicates that a few microbusiness program participants have been able to discontinue or reduce their public assistance.

- Meeting US WEST Foundation's expectations for the program.

The MBFP has made some progress, but has generally come up short in fulfilling the US WEST Foundation's expectations for the program for 1994. Measures of MBFP performance are through October 1, 1994.

Total loans- US WEST goal is \$4.3 million, MBFP loans made are valued at \$1.86 million.

Jobs created or retained- US WEST goal is 860, MBFP businesses employ 340 persons (270 FTEs).

Welfare/UI caseload reduction- US WEST goal is 260, no figures are available, but impact to date has been slight.

Ratio of dollars loaned to job created/retained- US WEST goal is \$5,000 loaned per job, MBFP average cost is \$5,5000 per job (full- and part-time) and 6,900 per FTE.

Business survival- US WEST Goal 80 percent, no figures are available, business survival is greater than 80 percent.

Loan losses- US WEST goal at or below 3.5 percent, MBDC loan losses are 4 percent.

BENEFIT-COST ANALYSIS OF THE MICROBUSINESS FINANCE PROGRAM

The intent of a benefit-cost analysis is to see whether the program provides benefits sufficient to warrant its costs. To do this, the analysis must consider costs and benefits that affect different parties, including state government, the MBDCs, and the public as a whole. Projections of program benefits indicate that the Microbusiness Finance Program is generating benefits that are greater than costs, and that the MBFP is a productive use of state funds and is an appropriate use of Coal Tax Trust Funds.

Program benefits and costs include those affecting state government, such as increased tax revenues and reductions in assistance payments, but the major benefits of the program are the value to the public provided by businesses established. One measure of this benefit is the value of the goods and services the businesses provide to consumers (less the cost of producing them). This measure is referred to as a "profit measure" because it is closely related to the standard definition of profits. A second measure also counts the income the businesses provide to their owners and employees. This measure is referred to as "value added."

The "Montana" perspective benefit-cost analysis includes benefits and costs to state government plus the projected net benefits provided by the microbusinesses funded under the program.

State government also is not the only entity putting resources into the loan program. The program is regionally administered by 11 MBDCs, and additional resources are devoted to the program by advisory boards, public and private agencies and individuals offering voluntary technical assistance. The MBDCs also face capital writeoffs due to bad loans. To incorporate this concern, a second perspective benefit-cost analysis is included: a "societal" perspective includes as costs the resources put into the program by entities outside state government.

Elements of the benefit-cost analysis are as follows (benefits are discounted present values to October 1, 1994, and costs are cumulative costs, including interest, to the same date):

1. Benefits and Costs to Montana.

A. Benefits

- Microbusiness benefits. Projected by modeling the future performance of the businesses funded under the program over the first year of operation and five subsequent years. The present value of benefits is \$4,530,000 for the profit measure and \$16,530,000 for the value added measure.
- Increased state income tax revenues are \$919,000.
- Grants and pass-throughs. The US WEST Foundation provided \$415,000 in grants mainly used to fund MBDC operating costs. (Pass-throughs do not affect Montana net benefits, and the full resource costs of MBDCs funded through grants are counted in social net benefits).

B. Costs

- The opportunity cost of the loan funds is the interest lost by not leaving the \$3.25 million in the Coal Tax Trust Fund. Net interest losses are \$448,000, which consist of \$685,000 in foregone Coal Trust interest earnings, less \$226,000 in interest payments from MBDCs to the DOC and \$11,000 in DOC short term interest earnings.
- Department of Commerce costs to administer and track the performance of the program through Oct 1, 1994 (39 months) are \$264,000.

Table 1		
Costs and Benefits to Various Entities		
Entity	Costs	Income or Benefits
State Gov't.	Opportunity cost of loan funds	Interest income from MBDCs
	Administrative costs of program	Increased taxes from funded business
	Foundation grant pass-throughs	Foundation grants
	Capital writeoffs	Decreased general assistance
MBDCs	Interest payments to State and other parties	Interest income from borrowers
	Administrative costs of MBDCs	Passive interest earnings
	Technical assistance costs	Foundation grants and parent contributions
Borrowers	Interest payments to MBDC	Gross business income
	Fixed and variable business costs	Long-term increase in earning power due to training
	Reduced general assistance	Self-sufficiency (low-income)
	Taxes	
Society	Opportunity cost of loan funds	Value of goods and services to the public
	Administrative costs of state and MBDCs	Long-term value of training
	Business costs less interest	Self-sufficiency
	Capital writeoffs	
	Environmental costs	

C. Net Benefits to Montana

- Total Montana benefits, using a profit measure for business benefits plus increased personal income tax revenues, plus adjusting for interest paid by the microbusinesses, are \$5,530,000. Total Montana costs (net of interest earnings) are \$710,000. Net benefits are \$4,820,000. Using value added as the measure of business benefits, and adjusting for interest, total benefits are \$16,710,000 (income tax revenues are not counted in this case), and net benefit are \$15,990,000. The benefit-cost ratios for Montana are \$7.8 to \$1 and \$23.5 to \$1 for the two benefit measures.

2. Benefits and costs to society as a whole.

A. Benefits

- Societal benefits are the same as benefits to Montana; the profits generated by microbusinesses funded under the program, or the value added generated by those businesses. (Taxes and some other items are treated differently in a societal perspective). Societal benefits are \$4,710,000 using a profit measure of business benefits, and \$16,710,000 using a value added measure.

B. Costs.

- "Montana" benefits are leveraged by resources put into the program by others. A societal perspective counts the costs of these resources. Costs to society are those borne by state government plus those borne by other parties, mainly the MBDCs.
- Administrative costs of the MBDCs, cumulative with interest from their certification date to October 1, 1994, are \$860,000. MBDC loan writedowns are \$80,000.
- Total societal costs, including opportunity cost of the loan fund, DOC costs and MBDC costs. \$1,660,000. (Note that environmental costs should be included here if they can be estimated and valued; they were not included in this study).

C. Societal net benefits.

- Societal benefits, (projected business benefits using a profits measure, adjusted for interest paid by microbusinesses, but not counting tax revenues), are \$4,710,000. If value added is the benefit measure, total societal benefits are \$16,710,000. Societal net benefits are \$3,050,000 and \$15,050,000, and benefit-cost ratios are \$3.0 to \$1 and \$10.6 to \$1 for the two measures.

Cautionary note: Some of the businesses financed by the MBFP, like new small businesses everywhere, will probably not survive or will pay the owner less than a living wage until he or she moves on to try something else. Most of the businesses modeled showed losses or zero or near-zero profits. The bulk of the benefits estimated here are generated by a minority of the businesses that have found successful niches and are likely to expand. At this point the businesses are too new for a firm evaluation of their competitive performance. Also, data on the actual financial performance of borrowers was not collected by most of the MBDCs and business profits and value added were estimated by modeling, under conservative assumptions based on business plans filed with loan applications, rather than by statistical analysis of their actual performance. Despite the clear finding of positive net benefits for the program, this study should be redone in a few years when the microbusinesses have established track records and their actual performance can be used to assess the net benefits of the program.

ISSUES AND RECOMMENDATIONS

The following section briefly discusses what evaluators feel are the most important issues affecting the future success of the Microbusiness Finance Program. Additional issues are identified and discussed in Chapter III of the report.

Issue 1. Establishing and Maintaining Sufficient Lending

Establishing and maintaining sufficient volumes of lending appears to be the most pressing issue facing the Microbusiness Finance Program. The long-term success of the program depends on performance of all the MBDCs. Only 5 of the MBDCs are meeting the targets for outstanding loans provided for in their contracts with DOC. In the fall of 1994, program lending is 13 percent less than expected. Some of the newer MBDCs are making slow progress in coming up to speed; and, some of the older MBDCs, who previously established excellent lending records, have become increasingly inactive. Without effective marketing of microbusiness loans, the program will under-accomplish its economic and societal goals, and will become a financial burden for its state and local sponsors.

There are several explanations for why certain MBDC lending rates are not meeting expectations, but a key reason is that the program lacks significant incentives for aggressive marketing and lending by MBDCs. Achieving targeted loan-out rates is more difficult for MBDCs serving smaller markets; however, the vigorous lending by the Havre MBDC demonstrates that demand for microbusiness loans does exist even in non-urban areas.

Recommendation: The Department of Commerce should institute incentive mechanisms that will reward MBDCs for high levels of prudent lending. There are a variety of ways this could be done. Grant pass-through allocations could depend, in total or in part, on lending levels. Additional loan funds, if approved by the legislature, could be made available to the MBDCs only as they are used, remaining in the Trust Fund until they are allocated. Inactivity could be cause for portions of the funds already allocated to revert to the Coal Tax Trust Fund for reallocation to other more successful MBDCs. The incentive for making microbusiness loans would be increased if DOC is able to reduce interest rate it charges MBDCs for loan fund principal. DOC also could heighten the profit incentive by charging lower interest rates to MBDCs with higher lending volumes. Parent organizations could also build pay incentives into the MBDC budgets to encourage aggressive marketing by the MBDC loan officers. MBDCs and the DOC also could collaborate on implementation of statewide and regional marketing of the Microbusiness Loans.

Issue 2. Long-term Survival of the Loan Funds

An expectation in allocating Coal Tax funds to the microbusiness Finance Program was that MBDC loan funds would be self-perpetuating and would not be eroded by loan losses. Microbusiness loans, particularly for startups, carry greater risk than most other business loans. Interest rates paid by microbusiness borrowers, and therefore MBDC interest income, do not reflect loan risk. Some MBDCs already have experienced loan losses, without sufficient income or reserves to cover them.

All of the MBDCs are attempting to establish Loan Loss Reserve Funds to protect their loan fund principal. Loss reserves can be used to restore loan fund principal in the event of defaulted loans. MBDC loan loss reserves currently average about 6 percent of outstanding loans. Only one MBDC has loan loss reserves of greater than 10 percent, and it is the only MBDC which feels its reserve fund is adequate. Most MBDCs lack the income resources necessary to build adequate reserve funds (a few MBDCs have been able to fund reserves from excess local matching moneys).

In addition, for a reserve fund to provide long-term protection for loan fund principal it must be restored after it is used to replenish a loan fund. MBDC interest earnings appear to be inadequate to serve as a primary source of MBDC operations funds and to adequately fund reserves; and, in the long-term provide for periodic replenishment of loan losses.

Recommendation: At a minimum it is essential for MBDCs to recognize loan losses in their cost accounting by promptly writing off bad loans. MBDCs need to be aware of the unfeigned status of their loan portfolios, so they can adequately accommodate losses in their lending and budgeting decisions. Such a procedure will do nothing to maintain the integrity of the loan fund principal, but will help to prevent MBDC insolvencies.

The DOC should solicit the input from the Microbusiness Advisory Council (MBAC), MBDCs, the private sector financial community and elsewhere to determine best methods for protecting MBFP loan fund principal against losses. If funding and maintaining a Loan Loss Reserve Fund is determined to be the best alternative, the DOC and MBDCs should work together to establish appropriate levels for the loss reserves and identifying means for building and sustaining these funds.

Most MBDCs favor using local matching monies to build loan loss reserves, in lieu of using these moneys to expand their loan fund's principal. Another alternative would be to simply fund the reserve with a portion of the loan fund principal (allocated proportionately between state and local contributions). The downside of both of these proposals is that they diminish the amount of total capital available for lending and reduce potential program benefits. Another approach for initially building loan loss reserves would be for MBDCs to allocate a high portion of near-term interest earnings to building-up loan loss reserves. This approach necessitates the substitution of grants and other funding to pay for MBDC operations costs. If funded loss reserves are part of the solution, consideration should be given to having the Board of Investments manage them.

In lieu of funding a loan loss reserve, MBDCs should consider reinvesting earnings and other income to build-up their loan fund's principal. A well managed MBDC should be able to profit more from interest earnings on the additional microbusiness loans than from earnings on a reserve fund's passive investments. The latter approach also would expand program benefits by providing additional lending capital. In this approach, coal tax funds would be protected only if MBDCs maintained a high rate of prudent lending. In the absence of a tangible (funded) loan loss reserve, forthright accounting of loans becomes critical.

An alternative to MBDC maintained reserves would be for DOC to build and manage a central loss reserve fund on behalf of the MBDCs. This suggestion would require DOC to charge slightly higher interest rates to MBDCs, and would reduce MBDC interest earnings and accountability for their lending practices.

An innovative alternative for building and maintaining a loan loss fund is to set interest rates at levels that cover the risk of failure. Interest rates would need to set high enough that MBDC interest earnings could sufficiently fund loan loss accounts or directly replace losses to loan fund principal. Such risk-adjusted interest rates would cover losses over the long run, but they would probably be impossible for the microbusinesses to pay. DOC and/or the MBDCs would need to develop outside funding to "buy down" the interest rate to levels affordable to borrowers.

Issue 3. Financial Self-sufficiency of MBDCs

MBDCs were not expected to be financially self-sufficient in initial years of program operation, but eventually interest earnings were to cover all or nearly all of MBDC administrative costs. MBDCs' interest earnings from microbusiness loans are developing about as expected, but are insufficient to cover

the costs of regionally administering the program. (Original income projections were based on fewer MBDCs, each with a loan fund of \$1.2 million. Original projections also anticipated much greater MBDC earnings from passive investments). Most MBDCs report annual operating costs in the range of \$40,000 to \$60,000. At current levels of loan fund capitalization, interest earnings on microbusiness loans are unlikely to cover even half of aggregate costs of MBDC operations.

Self-sufficiency is a goal often discussed for the MBDCs, but the size of the loan fund, the number of regional MBDCs, staffing requirements, the maximum loan size, the need to provide technical assistance, and other competing goals make self-sufficiency unattainable. Foundation funding, which has been of great help in running the program so far, is probably not a secure long-term source for operating revenues.

Recommendation: The Department of Commerce should study the prospects for self-sufficiency among the MBDCs, and set achievable goals for the type and level of costs to be covered by MBDC interest and other earnings. A reasonable course of action might be to aim for earnings to cover the administrative costs of the program. That is, interest and fees paid by borrowers should ultimately cover the costs of making loans and managing the loan portfolio.

At current loan fund capitalization, program interest earnings and client user fees will not come close to paying for the costs of MBDC technical assistance and training services. Stable and long-term outside funding is needed to sustain these services. Such support might come from legislative economic development appropriations, Vo-Tech or university continuing education programs, SBA or other federal business development programs, or local governments. DOC and MBDCs should continue to pursue grants, but this type of funding is likely to eventually dry up.

The DOC and MBDCs should identify and implement options for reducing the costs of regionally implementing the program. Individual MBDCs should analyze cost information in order to assess their program's efficiency. MBDCs also should analyze their incremental costs, and evaluate the actual financial burden of running the program versus not running the program.

MBDCs should collectively implement cost sharing of basic support functions. Aspects of fund investing may be consolidated. Another option would be for the DOC and State Board of Investments to provide support services for MBDCs. Where feasible, MBDCs should also encourage out-of-house provision of post-loan technical assistance and training by SBDCs and other business assistance organizations. As a last resort, some regional MBDCs should be consolidated.

Issue 4. Expanding Loan Fund/Increasing Maximum Loan Size

Increasing the loan fund principal, raising the maximum loan size, and lowering the interest rate charged to MBDCs for microbusiness funds are the only ways the regional MBDC operations will ever approach financial self-sufficiency.

There is a proposal before the 1995 Legislature to allocate another \$3.25 million of Coal Tax funds to the Microbusiness Finance Program and allow MBDCs to make loans of up to \$35,000. The proposal has a potential to significantly improve the self-sufficiency of MBDCs, expand business and job creation, and increase the social and tax revenue benefits of the program.

Increasing program lending capital will permit DOC to fund its operations with a much lower interest rate. The combined effect of expanded lending capital and a higher net interest earnings spread on loans should substantially increase MBDC profits. As the program matures, average annual interest earnings per MBDC should exceed \$40,000 a year. Increasing the maximum loan size to \$35,000 could provide start-up and expansion capital for slightly larger businesses. The economies of scale achieved in making larger loans also should help to make MBDCs more profitable.

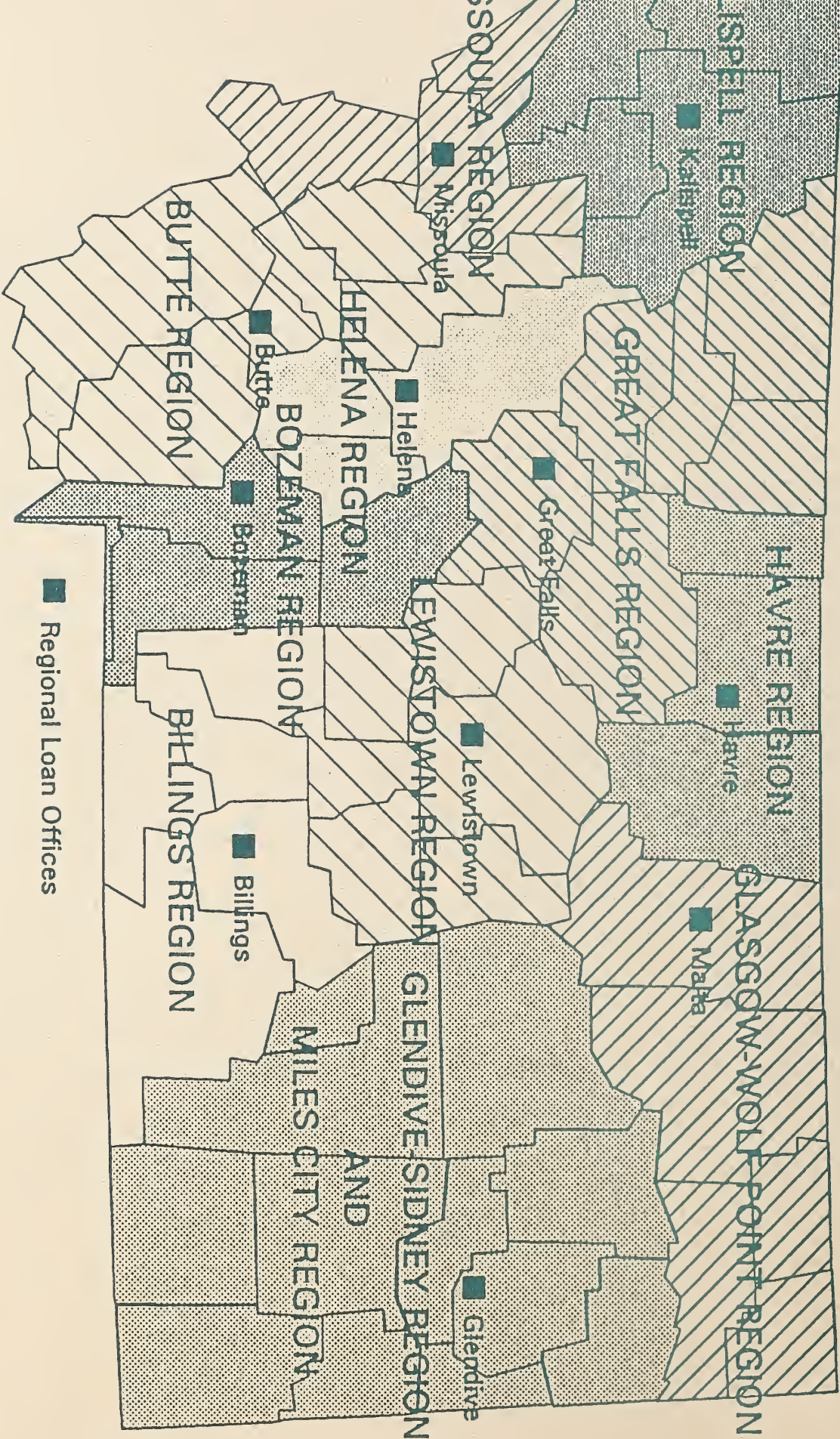
There is a question as to whether MBDCs will be able to loan out an additional \$3.25 million. Current performance suggests that some MBDCs will have difficulty in lending the additional funds. MBDCs feel there is a viable market for \$20,000 to \$35,000 microbusiness loans, and the MBDCs ability to loan out additional funds will be enhanced by increasing the program's maximum loan size (MBDCs estimate they could make \$2 million in \$20,000-\$35,000 loans in 1996). Most MBDCs are likely to have difficulty raising the \$1 to \$6 match required to receive additional funds.

Recommendation: The Microbusiness Loan Fund should be enlarged. However, program lending capital should only be increased if the Legislature allows MBDCs to make larger loans. Otherwise several MBDCs will have difficulty in marketing the additional funds.

Rather than immediately advancing MBDCs the full amount of enlarged loan principal, DOC should consider providing MBDCs with something similar to lines of credit. This proposal is intended to foster more aggressive marketing by MBDCs, and indirectly strengthen their financial self-sufficiency. An additional benefit of incremental allocation of additional loan funds is that local matching moneys can be developed in smaller amounts. The incremental allocation of new loan funds also will prolong state interest earnings from the Coal Trust. The Legislature also should consider reducing or eliminating matching requirements for second round loan funds.

The DOC should establish and enforce performance schedules for the lending of additional loan fund moneys. If an MBDC is unable to meet its agreed upon lending schedule, a portion of its unloaned principal would be made available for lending by other MBDCs. Increasing the maximum loan size to \$35,000, further reinforces the need for MBDCs to build adequate system for dealing with loan losses. MBDCs should be cautioned not to de-emphasize their smaller loan portfolio.

MICROBUSINESS DEVELOPMENT CENTERS



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